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MEMORANDUM

The Crisis in US-West European Economic Relations

1. Although the direct economic stakes of the current US-European disputes over agriculture, steel, East-West issues, etc., are small, the fallout of the disputes could have substantial long-term implications for the world economy and the alliance.

Economic Problems Worsen

2. The disputes involve a variety of conflicting interests and perspectives, some of long standing. What has brought them to a "crisis" stage, however, are a coincidence of issues and some serious failures of US-European communication which have bred widespread publicity and speculation and raised mundane differences to the level of high policy.

3. Some of the specific economic disputes, notably over EC agricultural policies, are of long standing.

- Even so, the detrimental impact of the EC's common agricultural policies on US agricultural interest has continued to increase.

4. Other specific economic issues, such as the steel issue, are of more recent vintage, but will not soon go away.

- The US and West European steel industries are severely depressed not only because of the economic recession, but also because of a long-term decline in the world demand for steel coupled with continued growth of the steel industries in LDCs.
- Disputes over East-West economic relations (see below) exacerbate the tensions inherent in East-West relations.

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5. Ordinary economic issues are now politically more sensitive than usual because of the high unemployment rates both in the US and in Western Europe.

- It is widely believed in Europe that a major factor impeding their economic recovery is the high US interest rates and their transmittal to Europe.
- In addition, the Europeans are pessimistic about their long-term economic prospects; they believe they are behind the US and Japan in advanced technology and that technological change will bring with it a continued high level of ^{un}employment.

6. The recession and the long-term structural problems create a need for major and generally painful economic adjustments in the US and Western Europe--for example, the need to reduce capacity in the steel industry and restructure its technology and production.

- European traditions, especially on the Continent, are more interventionist than in the US in handling major economic adjustments.
- The more difficult the problem the harder it will be to reconcile these different approaches, even where, as in the case of steel, the objectives are the same.

7. In the broad area of international trade and investment, protectionist forces are building and it is harder to find common ground between the US and Europe for lowering barriers.

- The cyclical and structural problems just described are spawning protectionist demands both in the US and in Europe.

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- At the same time the potential for reducing barriers to international transactions under accepted rules is now very limited--tariffs are low or nil.
- A good start in attacking non-tariff barriers was made in some of the codes negotiated in the GATT, but these barriers are inherently difficult to identify and police.
- The expansion of GATT rules to cover services and direct investment, as requested by the US, is controversial; it will be difficult to find broad common ground with the Europeans on these issues, and existing rules do not cover them.
- An economic recovery would ease these problems, but would leave unemployment rates high, at least in Europe.

The East-West Problem

8. Although cyclical and structural economic problems have made the handling of economic conflicts more difficult, the major new element in the current crisis is the coincidence of major differences over East-West economic policy.

- The West Europeans have been unwilling to give up detente in Europe because of Soviet expansionism in other parts of the world. They have not given the US credit for shouldering the burden of protecting their interests in the Middle East, Africa, etc.
- They regard trade with the Soviet Bloc as a stabilizing element in East-West relations, and consequently as a factor enhancing their national security.

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- In addition, they are strongly opposed to any reduction in their exports at a time of high unemployment.

9. Besides these different perspectives in East-West economic relations, there has been genuine confusion in Europe over US intentions and motives.

- Numerous statements from high-level European officials, some reflected in press comment, but others not designed for public consumption or bargaining, clearly show that the Europeans have been confused about US policy regarding economic relations with the East. They got different impressions from different US officials and did not know which to believe.
- Faced with this uncertainty, but observing US actions, most Europeans drew the conclusion that the real US objective was simply to apply economic pressures against the USSR by any practical means--and they were against that.
- The Europeans apparently were somewhat encouraged by the agreement at the Economic Summit--indicating in their view that US policy was less hard line than they had previously thought. But the President's decision on pipeline sanctions dashed these hopes and left the Europeans angry and confused.

10. The Polish issue and the question of whether and how to differentiate between the USSR and Eastern Europe and among East European countries are further complicating the policy debate. Specific questions include:

- How to react to any easing of martial law in Poland?

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- How to handle the rescheduling of Polish debt?

- How much to help the Hungarians?

11. By far the most sensitive East-West issue is extraterritoriality.

- This is nothing new. Our allies have always been exceedingly sensitive about any extension of US law and policy to their own countries.
- The countries with traditions closest to ours (the British and Canadians) react even more strongly than the others in this area.

European Reactions

12. So far the Europeans have reacted to the crisis mostly rhetorically, but there may soon be some tangible effects:

- The reaction to nearly all new US East-West initiatives--for example, on regulating credits to the Soviet Bloc through cooperation in NATO--is being strongly rebuffed by the French and the reaction of other countries ranges from negative to lukewarm.
- The Europeans may take retaliatory steps on trade issues which are of long-standing, but have been held in abeyance. For example:
 - Placing quantitative limits on EC imports of soybeans and corn gluten from the US;
 - Bringing a complaint against DISC before GATT.
- The British government has taken a preparatory step to implement its law to prevent the application of US law to US subsidiaries located in the U.K.
- The French government released military equipment for Nicaragua, which had been on hold because of US requests.

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13. The longer term fallout from the dispute, if it is not reined in, could be serious.

- A major trade war is highly unlikely; it would severely hurt both sides, but the Europeans even more than ourselves.
- But the US initiatives to expand the GATT to include services and investment will meet a cold reception; in the absence of some progress on the multilateral front, specific protectionist pressures will hold sway.
- And the US position in both Soviet Bloc and West European markets for certain industrial products and technologies--especially, oil and gas equipment--will be damaged as the Soviets seek secure sources of supply and the Europeans develop alternative technology and capacity.

14. An extended period of worsening US-West European relations is also bound to affect the military and political aspects of the alliance.

- For example, the odds have favored Belgium's acceptance of US missile deployment, but the Belgian political balance is highly unstable and it would not take much to push the Belgians over the edge on this issue. A negative Belgian decision would have a negative impact on the other small countries.
- More generally, the willingness of West European countries to increase their military expenditures, to engage in military burden sharing, and to undertake joint weapons development projects with the US would probably be lessened.

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Implications for Policy

15. The purely economic issues are difficult, but could be managed without any abandonment of US interests or any serious fallout for the alliance or the world economy. The US-West European relationship could probably be brought back on track if the following conditions existed:

- The US enunciates and adheres to a policy on East-West economic relations that the Europeans can understand.
- The US shows concern for and interest in Europe's problems even where economic interests conflict--a matter of style as much as substance.
- Various channels are developed for better consultation with the Europeans.
- The extraterritoriality aspect of our export controls on oil and gas equipment is dropped.

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